Substitution and "back-up strategies" are likely to play much smaller roles in the COLR auction than in the spectrum auctions, because the COLR obligations to service various areas are not technological substitutes. As in the PCS auctions, some substitution possibilities could be generated by a firm's service capacity limitations. Limited budgets could also lead bidders to seek a limited number of COLR obligations. However, the important technological substitution possibilities will be missing.

As against these advantages for the simultaneous multiple round auction, the sealed bid auction has advantages of simplicity and reduced vulnerability to collusion. Any pre-auction collusive agreement among bidders will tend to collapse in the sealed tender auction proposed here because each bidder has a straightforward and powerful incentive to defect from it.

Even if collusion were not an issue, the costs of administering a simultaneous multiple round auction for both the regulator and the bidders may not be worth the benefits. In the PCS auctions, the values of the individual licenses were substantial in comparison to the administrative costs of running the auction and the problem of collusion appears to have been of minor importance. The benefit-cost analysis in this case thus looks quite different than that of the PCS auctions.

c. **Determining the support paid to winning bidders.**

According to the optimal auction analysis in section II, if the bidders respond "rationally" and competitively to one another's strategies, then a variety of rules can be used to determine the support payment without affecting the efficiency of the overall design. Choices among these support rules must therefore be determined by factors apart from those built into the optimal auction model. These factors include (1) the ease or difficulty for bidders of determining their best ("rational") bid, (2) the vulnerability of the rule to collusive behavior, and (3) public perception of the rule as fair and reasonable.

Among the payment rules that might be acceptable according to the optimal auction theory are: (1) the payment is set equal to the lowest rejected bid or to the reserve if all bids are accepted and (2) the payment is set equal to the highest accepted bid. The first of these rules performs poorly in the public perception (as the experience of the New Zealand spectrum auctions demonstrates) and is vulnerable to some collusive bidding patterns.[19] The second rule is readily perceived as fair and reasonable, since it allows the bids to be interpreted straightforwardly as the lowest level at which the bidder offers to supply service. For that reason, I favor it.

d. The number of COLRs.

I would propose that the Commission permit the designation of multiple COLRs for any particular area, the number depending on the differences in the bid amounts. Lacking any quantitative basis for the assignment rule, I tentatively propose the rule described in the previous section. To repeat, that rule is as follows.

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[19] If the reserve is known to the bidders to be very high, there is a Nash equilibrium in which the bidders each bid zero and receive the reserve as their subsidy. This outcome leads to the same kinds of losses that we identified earlier for other forms of collusive behavior.

Case	Condition	Outcome
1	At least one competing bid is within 15% of the lowest bid.	All who bid within 15% of the lowest bid become COLRs.
2	No competing bid is within 15% of the lowest bid but one is within 25%.	The two lowest bidders become COLRs.
3	No bid is within 25% of the lowest bid.	The lowest bidder becomes the exclusive COLR.

There are three advantages of a rule such as this. First, it encourages competition within the market for the patronage of potential subscribers. Second, the presence of multiple COLRs may ease the Commission's burden of monitoring and enforcing the performance of the COLRs after the auction, for several reasons. If some COLR is tempted to avoid serving the highest cost subscribers in a service area, the other COLRs will be led to detect and report that in order to avoid being forced to serve a disproportionate share of those subscribers. Multiple COLRs also provide the regulatory authorities an opportunity to compare the performance of several COLRs in the same market, making it easier to detect false claims about the impossibility of providing some promised services. Moreover, the Commission's threat to impose sanctions, including possible termination of a company's COLR status, is more credible if there are alternative COLRs available to protect consumers against service disruptions.

Third, the approach I have proposed accounts for both the declining benefits from designating multiple COLRs and the cost increases that may accompany a larger number of COLRs. When the bids of the participants are relatively close, the cost disadvantages from multiple COLRs will be correspondingly small, resulting in greater net benefits from multiple COLRs. In this case, the rule would designate multiple COLRs. When the cost differences are larger, the net benefits from multiple COLRs will be smaller, and the proposed rule would limit the number of COLRs designated.

e. The "official" reserve and the auction initiation.

For each CBG, the Commission should establish a maximum support level or "reserve" equal to the difference between the standard rate for the basic service package and a multiple[20] of the cost estimate of providing that package based on an estimation model such as the CPM or BCM. The primary purpose of the reserve is to limit the required support payment in areas where only the LEC can provide economical service. However, the ceiling created by the reserve will also encourage somewhat lower bids in the auction.

After the official reserves have been set, the Commission (or the state PUCs) should allow bidders to nominate CBGs for inclusion in the next auction. This could be done by asking interested parties to submit a Notice of Intent by some specified date before each auction. If the auction for a particular CBG attracts any valid bids from any bidder besides the incumbent LEC, the auction is held; if it attracts no bidders or if only

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[20] As I have already explained, the reserve needs to be based on a multiple of the estimated cost in order to allow the auction to correct errors – both overestimates and underestimates – in the cost estimates and to mitigate the "selection bias" that would be otherwise created.

the incumbent LEC submits a valid bid, the incumbent would retain the COLR obligations at the previously established support level based on a multiple of estimated costs.[21] Similarly, in any area where an auction has not yet been held, the incumbent LEC would retain the COLR obligation at the previously established support level.

For those CBGs for which auctions are held, the designated COLRs would be obliged to provide service beginning, say, one year or eighteen months after the COLR designation. This delay is to permit new entrants whose business plans call for additional facilities investments to make those investments after winning in the auction. This encourages the widest feasible participation in the auction.

f. Exploiting synergies in adjacent CBGs and withdrawal penalties.

Participants in the auction may bid on as many CBGs as they choose, thus permitting bidders some limited flexibility to account for economies of density and scale in their CBG-specific bids. Thus, if a particular entity bids for only one CBG and there are scale and density economies in serving that CBG and adjacent CBGs, then another entity can underbid the first entity in the one-shot auction format.

Some winning bidders may discover after the auction that the aggregation of the particular CBGs won would not permit the bidder to attain all of the expected synergies. This is likely to be a serious problem only if both of the following two conditions apply:

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[21] Any other rule would allow a non-COLR to affect the support price in an area merely by nominating a CBG for auction and without actually bidding, possibly encouraging mischievous nominations.

(1) the bidders' overall cost levels are similar and (2) the synergies are strong. The first condition makes it more likely that each bidder wins a COLR role in several areas, which is a pre-requisite for the problematic "checkerboard pattern," and the second is necessary for the consequences to be economically costly. To help remedy this problem when it is most severe, I propose that a winning bidder be permitted to withdraw its bid for some period after the auction. In effect, a bid withdrawal substitutes partially and quite imperfectly for combinatorial bidding.

When a winning bidder withdraws its bid for a CBG, the auction outcome would be determined by the remaining bids as if the withdrawn winner had never bid. (If only the incumbent LEC remains as a bidder, the auction is canceled, and the incumbent LEC receives support payments at the previously determined level.) This rule prevents any participant from using withdrawals strategically to trigger a new auction, thereby effectively turning a one-shot auction into a multiple-round auction.

Although withdrawals should be permitted, they also need to be penalized. There are two important reasons. First, the withdrawals may disrupt the outcome of the auction and the plans of other bidders and so need to be discouraged. Second, the lack of any penalty may encourage frivolous bidding, in which the bidder attempts to assemble unrealistic combinations or tries to mislead competitors about its future intentions. If there are no penalties, this sort of disruptive bidding behavior is riskless to the bidder.

To assist in maintaining the integrity of the auction, I would propose that the Commission establish moderate withdrawal penalties to deter frivolous bidding, as it did in the PCS auctions. To determine the withdrawal penalty, the Commission would assume that in the future, the winning COLRs would have equal market shares in the CBG. The penalty for a withdrawn bid might be equal to the larger of any increase in the twelve-month support obligation of the government as a result of the withdrawn bid or, say, $20 per subscriber in the CBG. The penalty protects the government from any increases in its support costs and provides some compensation for any loss in post-auction competition resulting from the frivolous bid.

g. The length of the COLR designation.

The length of the time period for which an entity is designated a COLR has several effects. First, a long period ensures that what a bidder wins by making a low bid is of significant value. Second, the period affects the pattern of investments that may be undertaken to provide COLR services.

Encouraging efficient investment is a subtle matter. Optimal investments require that today's COLRs properly anticipate the likelihood that superior technologies will become available tomorrow, replacing the COLR or cutting into its profit margins. Setting too long a period of protection discourages or even blockades entry when the new technology becomes practically available. Setting too short a period may require large initial support payments to allow the investor to recover its investment in a short period. Such support payments may exceed the reserves or be embarrassing to the regulator.

To balance these competing concerns, I have tentatively proposed a three year period for the COLR obligation. To account for cost increases during the interim, the Commission could periodically raise the support rate by an exogenous index of costs, in the same way that the Commission currently implements its price cap policies.

Further, to allow new entry to occur when it is ready, the three year period of protection might not apply to auctions in which the set of COLRs serving an area does not change, or changes by the exit of a COLR. The three year period of protection would then apply only when a new COLR is introduced into the group serving a particular CBG. The justification is that only a new COLR might be regarded as needing an initial period of predictable competition during which it amortizes its investment.

At the end of the three year period, the areas for which the COLRs were selected via an auction would be eligible to be nominated by qualified parties for a new auction. The rules for these auctions would be nearly identical to those for the original auctions, but taking into account that the COLR for an area may no longer be the LEC. Simply put, the FCC (or state PUCs) would once again announce an official reserve and call for bidders. If no notice of intent is received for a CBG or if there are no valid bids for it, then the incumbent COLRs retain the obligation to provide basic service at the original support rate.

h. Default penalties.

If a bidder defaults, the outcome could be determined as if there had been a withdrawal, as discussed above. However, the costs to the government and consumers will be more substantial the longer the time between the initial auction and the default. This is because the plans of other potential COLRs may have been seriously affected. Consequently, any replacement for the defaulted COLR is likely to demand a higher support level for the shorter-term obligation than for the initial obligation.

Because the COLRs are likely to be parties with continuing relations with the regulators, there are many ways for the Commission to discourage default. The Commission should explore whether it may modify any of its current regulatory penalties for the purpose of deterring the default of a COLR.

i. Transferability of the COLR obligation

As already noted, the proposed auction mechanism has only a limited ability to accommodate synergies in service provision across CBGs. To permit COLRs to realize greater economies after having some experience with the COLR obligation, I would permit a COLR to sell its COLR status to any other qualified company (for example, one that is a COLR in some CBG) that is a non-COLR in that particular CBG. That is, sale would permitted be to a qualified firm (as evidenced by its COLR obligations elsewhere) provided it does not reduce the number of competing COLRs in the affected service area.

Permitting the COLR to sell the obligation after the auction also permits a bidder whose costs are unexpectedly high to transfer the obligation to a more efficient provider.

IN THE UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

GTE Service Corporation, et al., Petitioners, v. Federal Communications Commission and United States of America, Respondents.	Case No. 96-3424 (Consolidated with Case No. 96-3321)

REPLY MEMORANDUM IN SUPPORT OF MOTION FOR STAY PENDING JUDICIAL REVIEW AND FOR EXPEDITED JUDICIAL REVIEW

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INTRODUCTION

Despite their great length, the papers opposing the motions for a stay conspicuously fail to confront the primary arguments overwhelmingly demonstrating that a stay is appropriate in this case. The FCC largely rehashes prior statements about its rules and never directly addresses GTE's arguments based on the text of the Act. And AT&T and others predictably charge that phone companies such as GTE are just monopolists desperately seeking to deprive consumers of the benefits of competition. After all, these parties -- who intend to start offering service over the facilities of existing local phone companies -- stand the most to gain from the FCC's veritable fire sale of the local network. The FCC's rules will subsidize their entry into the market.

There should be no doubt, however, that the posturing in the oppositions is simply that -- posturing. The parties who have the greatest impartial interest in rapidly securing the benefits of competition for consumers are the state commissions. And the Iowa Utilities Board and the Florida Public Service Commission have joined in seeking a stay of the FCC's rules precisely because they recognize the deleterious effects the rules will have in distorting the transition to competition. Thus, as these state commissions recognize, it is a stay of the FCC's unauthorized rules that will hasten the introduction of local competition according to the process outlined by Congress in the Act.

Much of the smokescreen the FCC and its supporters generate rests on three obvious errors.

First, on likelihood of success, the FCC relies on a not-so-subtle sleight of hand. To start, the FCC suggests that GTE's arguments rest primarily on § 2(b) of the Communications Act of 1934, which restricts the FCC's jurisdiction over intrastate matters. The FCC then points to provisions in the 1996 Act that on their face give the FCC some role in implementing local competition. From the obvious fact that the FCC has some legitimate role in implementing certain provisions of the Act, which GTE has never denied, the FCC attempts to draw the insupportable conclusion that Congress intended the FCC to issue national rules governing all aspects of the implementation of local competition, including the setting of prices. That is plainly wrong. Congress expressly reserved for the States the role of determining just and reasonable prices. That reservation of authority, moreover, is consistent with the role the Communications Act has always reserved for the States in setting intrastate rates. Indeed, neither the FCC nor AT&T even attempts to come to terms with the plain language of the Act, which unequivocally provides that "State commission[s] shall . . . establish any rates for interconnection, services or network elements." § 252(c)(2); see also § 252(d). The mere fact that Congress defined a specified role for the FCC in implementing local competition provisions does not mean that, contrary to the express language of the Act, the FCC may usurp the province of the States in setting rates.

Second, to counter GTE's showing of irreparable harm the FCC simply mischaracterizes the effect of its proxies. The FCC represents to this Court that "there is no certainty that [its] proxies will ever be applied to petitioners." FCC Opp. at 37 (internal quotations omitted). That is simply false. In the few short weeks since the rules were published, several States have already determined that they have no practical choice but to apply the proxies. See infra p. 11. And AT&T, while telling this Court that the proxies "in no way foreclose states from implementing different prices," AT&T Opp. at 32, is at the same time urging state commissions that, as a practical matter, they must apply the proxies to meet the deadlines in the Act. See, e.g., Letter submission of AT&T, In re Petition of AT&T Communications of Calif. for Arbitration (Sept. 13, 1996) (suggesting any approach other than the proxies is "obviously impractical"). Such a shell game should not be tolerated. And lest the Court have any doubt that the FCC's proxies are arbitrary and below-cost, the Florida Public Service Commission (PSC), on whose cost studies the FCC relied in setting its proxies, confirms in its motion for a stay that the "FCC's proxy rate . . . bear[s] no relationship to [a LEC's] actual costs" and that the proxies are clearly "arbitrarily low." Florida PSC Mot. at 15.

Third, in asserting that a stay would harm the public interest because it "would prevent the Commission's rules from guiding the terms of competitive entry, as Congress intended," FCC Opp. at 3, the FCC pins its argument on its own erroneous view of the merits. Since, however, petitioners are likely to prevail on their claim that the FCC lacks power to dictate national pricing rules, the public interest will be served by preventing the FCC's unlawful rules from "guiding the terms of competitive entry." A stay of the FCC's pricing rules will thus promote the rapid implementation of the Act in accordance with the procedures established by Congress.

I. GTE IS LIKELY TO SUCCEED ON THE MERITS.

A. The FCC Exceeded Its Jurisdiction By Imposing National Pricing Rules.

1. The text and structure of the Act explicitly reserve authority over pricing to the States.

In well over 100 pages of briefs opposing the motions for a stay, not a single party comes to grips with the central text of the Act demonstrating beyond doubt that the FCC exceeded its jurisdiction by promulgating national rules over pricing. Section 252(d) could hardly be plainer. It is a distinct section of the statute expressly addressing "Pricing Standards." It explicitly directs State commissions -- not the FCC -- to determine "just and reasonable rate[s]" based on standards outlined directly by Congress in the Act, and it nowhere makes any mention of rules on pricing promulgated by the FCC. Where Congress wanted the States to follow FCC rules in arbitrations, however, it clearly knew how to say so. Thus, in outlining States' duties, § 252(c)(1) explicitly requires States to ensure that substantive "conditions" imposed in arbitrations comply with both § 251 and with regulations the FCC is authorized to issue under § 251. In § 252(c)(2), however, Congress addressed distinctly the standards States should apply in "establish[ing] any rates," and -- omitting any reference to FCC rules -- only directed the States to apply the standards set out in § 252(d).

The FCC hardly even attempts to respond to the Act's explicit delegation of authority over pricing to the States. Indeed, instead of addressing the text of the Act reflecting Congress's decision to omit any role for FCC rules in pricing, the FCC would prefer to ignore it.[1] Thus, the FCC baldly asserts that the Court should disregard the fact that Congress directed the States to follow FCC rules in § 252(c)(1) but omitted any reference to FCC rules in the sections addressing pricing, see §§ 252(c)(2), 252(d), because "there was no need for Congress to refer to the Commission's rules in multiple subsections of section 252(d)." AT&T similarly suggests that the Court should ignore the absence of any reference to FCC rules in § 252(d) because, at least in this regard, the language of § 252(d) is "irrelevant." AT&T Opp. at 7. This reading is insupportable. It would render Congress's explicit direction to follow FCC rules in § 252(c)(1) superfluous by importing the same command into § 252(c)(2) and § 252(d), even though Congress excluded any reference to FCC rules in those sections. Cf. In re Bellanca Aircraft Corp. 850 F.2d 1275, 1280 (8th Cir. 1988) (rejecting interpretation that would render part of statute "mere surplusage").

Rather than making any serious effort to confront the terms of § 252(c) and § 252(d) directly, both the FCC and AT&T instead place great reliance on the mere fact that § 251(c), the provision setting out substantive duties imposed on incumbent LECs, also mentions the pricing standards fleshed out in § 252(d). The FCC then claims that, since § 251(d)(1) grants it authority to issue rules under § 251, this power must extend to issuing rules on prices. See FCC Opp. at 18-19; AT&T Opp. at 14-15 That argument is flawed in several respects. In the first place, as GTE has already explained, § 251(d)(1) is not itself a grant of authority. Rather, it simply requires the FCC to act

[1] At one point, the FCC simply misrepresents the text of § 252(c) by suggesting that the obligation under § 252(c)(1) for States to ensure compliance with the FCC's regulations applies to both the "conditions" imposed in arbitrated agreements and to prices. See FCC Opp. at 14. As explained in the text, that is flatly wrong.

within six months in those areas where it has been given authority. More importantly, § 252(d) makes it clear that States have the role of defining "just and reasonable rates" "for purposes" of implementing the duty imposed in § 251(c). See § 252(d)(1). In other words, § 251(c) and its reference to just and reasonable rates cannot plausibly be read as implying an independent grant of authority to the FCC over pricing terms since § 252(d) expressly states that, for purposes of § 251(c), it is state commissions that will implement the Act by defining just and reasonable rates.

Merely to recite the FCC's contrary interpretation is to expose its absurdities. In essence, the FCC's unstated version of the relationship between § 251 and § 252 would run like this. In § 251(c), Congress imposed duties on incumbent LECs, including for example the duty to offer services for resale "at wholesale rates." Then in § 252(d)(3) -- a section entitled "Wholesale Prices for Telecommunications Services" -- Congress specified that "for purposes of § 251(c)(4)" (emphasis added) a "State commission" was to "determine wholesale rates" based on certain standards outlined explicitly by Congress in the text of the Act. Nevertheless, the FCC's argument goes, what Congress really intended by structuring the statute in this way was to assign the FCC authority to define wholesale rates and to relegate the States to the task of implementing the FCC's dictates. The FCC, moreover, would defend that interpretation even though elsewhere in § 252 Congress explicitly required the States to ensure compliance with FCC regulations, see, e.g., § 252(c)(1), § 252(e)(2)(B), and yet made no mention of any FCC rules on pricing. This interpretation is meritless. While § 251(c) does mention "just and reasonable" rates for interconnection and elements and "wholesale rates" for services, Congress gave content to those pricing standards in § 252(d) and expressly directed state commissions to implement the standards under the definitions in the Act.

Recognizing that the terms of the 1996 Act provide no authority for the FCC's pricing rules, both the FCC and AT&T resort to combing through the Communications Act of 1934 to glean references to general provisions granting the FCC authority to issue regulations. See FCC Opp. at 18 (citing 47 U.S.C. §§ 154(i), 201(b), and 303(r)); AT&T Opp. at 19-20. Indeed, astonishingly, such provisions are the FCC's first line explanation for its power over pricing. See FCC Opp. at 18. It should be plain, however, that such general provisions cannot legitimately be used to twist an explicit grant of authority to the States in § 252(d) into something that it is not -- namely, a grant of paramount authority to the FCC itself. See, e.g., Fourco Glass Co. v. Transmirra Prods. Corp., 353 U.S. 222, 228 (1957) ("specific terms prevail over the general").

2. Section 2(b) Confirms the FCC's Lack of Authority over Pricing.

To divert attention from its failure to address the terms of the 1996 Act, the FCC attempts to suggest that GTE's jurisdictional arguments rely "principally" on § 2(b) of the Communications Act and its explicit limitation on the FCC's jurisdiction over intrastate matters. See FCC Opp. at 20. The FCC then proceeds to distort GTE's position further by arguing that GTE's interpretation of the 1996 Act rests on the broad assertion that Congress restricted the FCC's authority and reserved control over intrastate matters to the States. See FCC Opp. at 24. See also AT&T Opp. at 4. The FCC and its supporters then attack that straw man by relying on a facile syllogism suggesting that if the Act gives the FCC authority over some intrastate matters, it must trump the restrictions of § 2(b) entirely and give the FCC authority over all matters addressed by the Act, including pricing. This argument is flatly wrong.

GTE does not dispute that the FCC was given authority over some intrastate matters in the 1996 Act. See, e.g., § 251(e) (FCC jurisdiction over numbering). But for purposes of the preliminary issues presented on the motions for a stay, the critical question is the FCC's authority over pricing. And contrary to the FCC's erroneous suggestions, the mere fact that the FCC was given authority over some other intrastate matters implies no grant of authority over rates. To overcome the "congressional denial of power to the FCC" in § 2(b), Louisiana Pub. Serv. Comm'n v. FCC, 476 U.S. 355, 374 (1986), there must be a "straightforward" and "unambiguous" assignment of authority, id. at 377. But there is no such delegation of authority to the FCC over pricing.[2]

B. The FCC Short-Circuited the Fact-Specific Price-Setting Mechanism Called For By the Act and Produced Arbitrary and Capricious Results.

The FCC cannot credibly dispute the fact that by setting proxy prices in an abbreviated rulemaking, it has hopelessly derailed the case-specific, evidentiary process Congress established for setting prices under the Act. At best, the FCC provides a two-step defense that seeks to obscure the real effect of its proxies. First, the FCC claims that the proxies do not displace the process called for in the Act, since the First Report and Order "encourage[s]" States to review actual cost studies. See FCC Opp. at 33. But whatever the text of the order may superficially recommend, the practical impact of the proxies on arbitrations is another matter. And as a practical matter, the FCC's rules have short-circuited the case-specific consideration built into the Act by effectively forcing States to

[2] The only provisions cited by the FCC do not even remotely imply a grant of authority over pricing. The FCC points to §§ 251(d)(3), 261(c) and 253. See FCC Opp. at 24-27. Section 251(d)(3), however, explicitly limits the FCC's powers. It states that the FCC "shall not" preclude enforcement of state rules that are "consistent with the requirements of this section" and that do not "substantially prevent" implementation of the section. From this the FCC would rely on a negative inference to derive a broad rulemaking authority that extends even to setting prices. Such a reading is fanciful. An express limitation on the FCC's authority cannot be twisted into a "straightforward" and "unambiguous" grant of power over pricing sufficient to overcome the restrictions in § 2(b). Section 261(c) similarly grants the FCC no authority, and instead merely notes that States may impose requirements on intrastate services that are not inconsistent with the Act and with FCC regulations under the Act. Merely by acknowledging that some FCC rules may address intrastate matters the section in no way implies a grant of authority over pricing. Finally, § 253 simply addresses the FCC's power to override provisions of state law that would erect "barriers to entry." Even if this section could be read to apply to pricing issues, which certainly are not included in its terms, it provides only a limited back-stop authority to rein in a State that has prevented entry into the local market. It clearly assumes that States will be implementing the Act in the first instance and provides that the FCC can only act with notice and comment after a particular state rule has been adopted. That is obviously a far cry from the power the FCC claims to preempt any State exercise of discretion by dictating rigid national pricing rules before the States have even acted.

apply the proxies immediately. Thus, States have already begun imposing the FCC's proxies in arbitrations. See infra p.11. To this, the FCC can offer no response whatsoever, and simply maintains -- in flat defiance of the facts -- that it is "entirely speculative" whether the proxy prices will ever be applied. See FCC Opp. at 37.

The FCC's second line of defense ultimately amounts to little more than a plea for leniency. See FCC Opp. at 33; see also AT&T Opp. at 33-34. The FCC effectively claims that, while the prices may not be based on studies that used its own pricing methodology, they are an interim solution and therefore close enough. But as the affidavits attached to GTE's motion and the submission of the Florida PSC make clear, the proxies most decidedly are not close enough to LECs' actual costs to satisfy either the statutory command that prices be based on "cost" or the standards of reasoned decisionmaking. To the contrary, they arbitrarily produce rates that drastically understate costs. As the Florida PSC has pointed out, the proxies set for Florida are "arbitrarily low," Florida PSC Mot. at 15, and given their method of calculation, the proxies generally "may bear no relationship to the actual cost[s]" of a LEC, id. Even if more lenient review might sometimes apply to a genuine stop-gap measure, that principle has no application here, where the FCC's so-called "interim solution" does not merely fill a gap, but rather displaces the individualized method for setting prices explicitly mandated by Congress.[3]

C. The FCC's Pricing Rules Violate the Terms of the Act.

Finally, in responding to GTE's argument that the FCC's pricing rules violate the Act because they would effect an unconstitutional taking, the FCC and others rely on an extravagantly overbroad

[3] The FCC is also wrong in asserting that, because GTE and others did not file a petition for reconsideration claiming that the proxy prices are arbitrary and capricious, these claims cannot be raised before this Court. See FCC Opp. at 33 (citing 47 U.S.C. § 405). The petition for stay before the FCC provided an adequate opportunity for the FCC to pass on these claims and thus preserved them for appeal. See Busse Broadcasting Corp. v. FCC, 87 F.3d 1456, 1461 (D.C. Cir. 1996).

reading of Duquesne Light Co. v. Barasch, 488 U.S. 299 (1989), and FPC v. Hope Natural Gas Co., 320 U.S. 591 (1944). Under this reading, because Duquesne and Hope focused on the "total effect" of a rate order in judging its constitutionality, the method used in setting the rate is simply irrelevant. Thus, the FCC contends that it cannot be determined yet whether its rules violate the Act, because the "end result" is not yet apparent,[4] and the method for setting prices cannot be challenged in itself.

The Court in Duquesne did say that it was the "impact" of a rate rather the "theory" behind it that was of primary importance. Duquesne, 488 U.S. at 310. But as Justice Scalia pointed out, by defining a constitutional standard that requires a regulated entity to be able to provide a fair return to investors, Duquesne and Hope necessarily imply that there is some constitutional minimum defining the investment base against which a return can be called "fair." See id. at 317 (Scalia, J., concurring). The issue in Duquesne, moreover, was whether a particular investment in a nuclear power plant had to be included in a rate base. The Court concluded that it did not, largely because the overall effect of excluding it was de minimis. See Duquesne, 488 U.S. at 311-12. That limited holding by no means suggests that an entire rate-setting mechanism can be constructed explicitly around the principle that all of a utility's actual, historical costs should be ignored.[5]

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[4] The FCC's effort to cast the issue in terms of ripeness is misplaced. GTE has not here raised a claim for compensation under the Fifth Amendment. Rather, GTE has argued that the Act cannot be construed to allow the FCC's pricing rules because, at a minimum, those rules raise a grave concern that they will effect an uncompensated taking. See, e.g., United States v. Security Indus. Bank, 459 U.S. 70, 78 (1982) (interpreting statute to avoid construction that would raise "substantial doubt" that statute comported with the Fifth Amendment).

[5] Hope would not support such a rate mechanism either. In Hope, the question was whether rates had to be based on the present "fair value" of a utility's facilities, or if they could be based on the lower measure of value provided by historical costs. See 320 U.S. at 602. The Court held the use of historical costs permissible, since rates under that measure would still allow the utility to provide a return to investors and continue to attract capital. See id. at 602-05. Hope nowhere suggested, however, that a rate mechanism would meet the constitutional standard if it proceeded a further notch lower by gauging a return so as not to cover even a company's actual, historical costs.

The FCC's pricing mechanism, by ignoring actual costs, ensures that an incumbent LEC will not be able to meet the constitutional standard of providing a return to investors sufficient to continue attracting capital. Where a rate-setting method wholly departs in this fashion from the basic criterion used for measuring its constitutionality, there can be no serious claim that a court must "wait and see" to find out whether the rate impairs a company's financial integrity before declaring the mechanism inconsistent with a command that rates be "just and reasonable." The FCC's method plainly raises grave constitutional concerns and thus is not a reasonable interpretation of the Act. See, e.g., United States v. Security Industrial Bank, 459 U.S. 70, 78 (1982).[6]

II. GTE WILL SUFFER IRREPARABLE HARM ABSENT A STAY

After spending virtually its entire brief on the merits, the FCC makes practically no effort to respond to GTE's showing of irreparable harm. GTE's central points thus stand unrebutted.

First, the FCC's rules will irretrievably derail the negotiation and arbitration process created by Congress. On this point there can be no real debate. AT&T, for example, openly acknowledges that its negotiating strategy has been to hold out for nothing less than the rates "that would result from the methodologies adopted" by the FCC. AT&T Opp. at 46. Indeed, the very premise of the order is the FCC's belief that meaningful private negotiations -- the principal means Congress chose for achieving competition -- are actually impossible, due to a purported "disparity in bargaining power" FCC Opp. at 8. Thus, the express purpose of the FCC's rules is to "reduce delay and lower the transaction costs" of negotiations, id. at 13, by preordaining the "rights and obligations" of the negotiating parties, id. at 8. Unless those rules are stayed, their purpose will undoubtedly be realized,

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[6] AT&T also erroneously suggests that the impact of the pricing rules can only be judged after taking into account LECs' revenues from unregulated aspects of their businesses. See AT&T Opp. at 24. Such extraneous revenues, however, cannot be counted in determining whether a rate mechanism is confiscatory. See, e.g., Brooks-Scanlon Co. v. Railroad Comm'n, 251 U.S. 396, 399 (1920) (Holmes, J.); cf. Northern Pac. Ry. v. North Dakota, 236 U.S. 585, 596 (1915).

and all remaining opportunity for effective private negotiations under the 1996 Act will be irretrievably lost.[7]

Second, it is now also beyond doubt that the FCC's pricing rules -- and particularly its irrationally low proxy prices -- will peremptorily dictate the results of numerous arbitrations in the next few months, to the imminent detriment of GTE. Astonishingly, the FCC's sole response on this point is the persistent claim that this harm is "entirely speculative," id. at 38, because "'there is no certainty th[e] proxies will ever be applied.'" Id. at 37 (quoting FCC Stay Order ¶ 12). See also AT&T Opp. at 47-48. Apparently, the FCC is utterly oblivious to the real-world effects of its order. The fact is that, at the urging of AT&T and others, state commissions -- believing they have no practical choice -- have already begun imposing the proxies on GTE in arbitrations. In California, for example, an arbitrator ruled that beginning in November the proxies will apply to GTE on the ground that "the FCC orders are clear [that] . . . where it is not feasible to fully address new cost studies within the time constraints of the specific arbitration . . . we would rely on the proxies."[8]

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[7] Relying on a snippet of legislative history, the FCC and AT&T also suggest that the rules can do no harm because Congress purportedly intended the FCC's rules to govern outcomes in negotiations and arbitrations. See FCC Opp. at 38; AT&T Opp. at 44-47. That response rests on a logical fallacy since it assumes the validity of the rules. The FCC cannot deny harm by reasserting its view of the merits Rather, in assessing harm, the Court must assume that GTE's challenge will ultimately prevail. And plainly GTE will be irreparably harmed if unlawful pricing rules dictate the terms in the negotiating process. In any event, the timetable in the Act shows no design to give the FCC's rules the influence the FCC claims. Negotiations could start immediately after passage of the Act and arbitrations could proceed after less than five months, but the FCC's rules were not due even to be announced (much less take effect) until six months after enactment. See § 251(d)(1).

[8] In re Petition of AT&T Communications of Calif., Inc. for Arbitration, Hearing Tr. at 1-2 (Sept. 18, 1996). Similarly, the Oregon commission has ruled that in the arbitration between AT&T and U S WEST, "the arbitrator will rely on the proxy prices established by the FCC." In re Petition of AT&T of the Pac. N.W., Inc. for Arbitration, Arbitrator's Mem. (Pub. Utility Comm'n of Oregon, Sept. 12, 1996). Numerous other state commissions will undoubtedly feel compelled to give in to the FCC's mandatory proxy prices in the next few weeks.

When they are imposed by state arbitrators, the FCC's below-cost proxies will effectively subsidize competitors like AT&T. As GTE has demonstrated, the unavoidable outcome of this artificial subsidy will be to allow entrants to inflict permanent losses of market share and goodwill on GTE during the pendency of an appeal -- losses that cannot be attributed to the efficiency or competitiveness of the entrants. See Supplemental Affidavit of Dennis B. Trimble; Affidavit of Orville D. Fulp; Affidavit of Donald M. Perry. Yet the FCC and its supporters nowhere make any effort to rebut GTE's showing of the impact the FCC's prices will have. Instead, they attempt to dismiss GTE's arguments with the erroneous assertion that "mere economic loss" is not irreparable harm. See FCC Opp. at 36. But "economic loss" manifestly does constitute irreparable injury justifying a stay where, as here, the loss is unrecoverable. See, e.g., Airlines Reporting Corp. v. Barry, 825 F.2d 1220, 1227 (8th Cir. 1987); Enterprise Int'l, Inc. v. Corporacion Estatal Petrolera Ecuatoriana, 762 F.2d 464, 473 (5th Cir. 1985).[9]

III. A STAY WILL NOT HARM OTHERS AND WILL PROMOTE THE PUBLIC INTEREST BECAUSE IT WILL PRESERVE THE STATUS QUO UNDER THE ACT AND ENSURE SPEEDY IMPLEMENTATION OF LOCAL COMPETITION.

To support its claims that a stay will disserve the public interest, the FCC asserts that "a 'stay' is a misnomer in this case, because it would not maintain the status quo." FCC Opp. at 3. That is nonsense. The status quo is the process Congress set in the Act: private negotiations, backed up by arbitrations in which the "State commission[s] shall . . . establish any rates for interconnection, services, or network elements." § 252(c)(2) (emphasis added). It is the FCC that is attempting to

[9] AT&T claims that GTE's rates in California will later be "trued-up" on the basis of full-blown cost studies -- suggesting that GTE might someday recover through cost-based rates some of the loss caused by the proxies. AT&T Opp. at 32 n.30. But the California commission has ruled that any subsequent revisions to interim rates will be applied to arbitration agreements "on a forward basis" only, and will therefore not make GTE whole. Resolution ALJ-168, at 4 (Calif. Pub. Utilities Comm'n Sept. 20, 1996).

alter that statutory status quo by arrogating to itself the power to set rates. A stay, on the other hand, would not in any way disrupt the process of implementing competition, but rather would allow it to proceed unimpeded by the distortions caused by the FCC's unlawful pricing rules.

Even the FCC admits that a stay would not impede the statutory process of implementing competition, and concedes that "[a] stay of the Commission's rules would not prevent the arbitration proceedings from going forward." FCC Opp. at 3 (emphasis added). That is GTE's whole point: a stay in this case in no way prevents the speedy implementation of competition precisely in the manner specified by Congress -- through private negotiations with the state commissions, not the FCC, determining just and reasonable rates when the parties cannot agree.

Having expressly conceded that a stay would not prevent the negotiation and arbitration process from going forward, the FCC's assertions that any stay -- even a limited stay of its pricing rules -- would cripple the process can only be based on the remarkable assumption that only the FCC, but not the States, can ensure that the rates set in arbitrations will be "just and reasonable." The FCC makes its assumption explicit as it points out that "[n]othing would do more to inhibit competition" than allowing "unreasonable rates" and asserts for that reason alone that it is inconceivable that "the Commission should have no authority over those rates." FCC Opp. at 26. Even putting aside the controlling fact that Congress determined that "State commissions" should have the role of "establish[ing] any rates," § 252(c)(2); see also § 252(d)(1), there can be no justification for the FCC's condescending suggestion that, with a stay of its rules in place, the States will ignore the statutory requirement that rates be just and reasonable and based on cost. With the characteristic attitude of a federal bureaucracy, the FCC automatically assumes an "only-we-in-Washington-can-do-things-right" view of the world that is a direct affront to the competence of the States. Indeed, the FCC's alarmist claim that only its pricing rules can prevent States from sabotaging the transition to competition reveals precisely the thinking that prompted the FCC's power-grab over prices in the first place: regardless of the choices Congress made, the FCC cannot conceive that anyone other than itself will do something right in implementing the Act.

That view is false. The simple truth is that, if this Court grants a stay of all or part of the FCC's rules, the statutory process for implementing competition will continue unimpeded. Private parties will continue to negotiate, States will continue to conduct localized arbitrations, and States will, where necessary, determine "just and reasonable" rates under the standards of the Act.

Even if the FCC's rules are upheld, there will be no harm to others from a stay in the interim. It will be far easier for parties to conform any variations in arbitrated agreements to the FCC's rules if the rules are later upheld than it would be for parties to re-work agreements adopted under the rules if the rules are struck down. While the FCC would like to dismiss this fact as merely a "self-serving" prediction by GTE, see FCC Opp. at 39 n.35, it should be obvious that it would require little effort to bring diverse arbitrated agreements into line with uniform federal rules, especially since state commissions will already have ensured compliance with the requirements of §§ 251 and 252. On the other hand, after a system of agreements based on a uniform national mold is in place, it will be impossible to recreate the atmosphere of free negotiations that would have existed had the parties approached the bargaining table without the shadow cast by the FCC's presumptive terms. Parties with working agreements inevitably will have reduced incentives to incur the costs involved in renegotiation and certainly will not reopen discussions on the full range of issues that would be on the table were they starting from a blank slate. In short, truing up any local variations to federal standards would be vastly simpler than attempting to move from a system of uniform agreements to create, after the fact, a system of negotiation and arbitration that never existed in the first place.

Moreover, since GTE, the Iowa Utilities Board, the Florida PSC and others are likely to succeed in their challenge to the FCC's national pricing rules, it is plainly the absence of a stay that will delay the implementation of competition. With a stay, the road to competition is a quick three-step process: first, the parties attempt to negotiate agreements (a process that is already finished in many places); second, the States conduct localized case-specific arbitrations; and third and finally, disappointed parties to the arbitration can seek review under the Act in federal district court.

By contrast, if a stay is not granted and (as is likely) the FCC's pricing rules are later struck down, the road to competition is, at best, a cumbersome, much-delayed seven-step process that will likely take years. First, the parties will conclude the initial negotiations under the cloud of the FCC's rules. Second, the state commission will conduct arbitrations where AT&T and others will assert (as they already have) that the state commission is bound to apply the proxies. Third, the FCC purports to create an additional step, under which parties disappointed with a State's application of the FCC's rules can seek review in front of the FCC. See First Report and Order ¶¶ 124-29. Fourth, parties will use the statutory review process in district court. Then, fifth, when the FCC's pricing rules are invalidated -- even assuming that the effects of the rules could be undone -- parties will be entitled to a new round of negotiations without the cloud of the FCC's order skewing the process. Next, there will be, sixth, a new round of arbitrations where the States are free to exercise their own judgment; and seventh and finally, review of the new arbitrations in district court. By delaying the transition to competition, this burdensome process will obviously frustrate Congress's goals in the Act. Given this prospect, the choice before the Court should be clear -- a stay is clearly warranted.

CONCLUSION

For the foregoing reasons, this Court should stay the effectiveness of the First Report and Order or, at a minimum, the pricing provisions in the FCC's rules. See §§ 51.501-51.515, 51.601-51.611, 51.701-51.717. The Court should also expedite judicial review.